

# Fixed Market Commentary

## Hooked on QE

September 30, 2016

The run up to the 2016 Presidential election more closely resembles a bad reality TV show than a process for choosing the “leader of the free world.” The craziness of this race has dominated the news cycle for many weeks. However, when all the dust has settled, the third quarter of 2016 may be better remembered as the time when world central bankers finally recognized the limits of monetary policy. Central banks have flooded the planet with liquidity since the Great Recession of 2007. Various iterations of quantitative easing have been attempted by the Fed, the ECB, the BOE and the BOJ for several years. What was expected to be a temporary jolt to the heart of the financial system has morphed into a long-term addiction for a world hooked on QE. On one hand, QE has successfully propped up assets prices in many countries. On the other hand, the anticipated follow through to the “real” economy has failed to materialize. So while stock prices have soared, economic growth has been lackluster for years.

The Bank of Japan was probably the first member of the AA support group to stand up and admit they have a problem. “True believers” in QE were convinced that the only reason QE wasn’t working as expected is that previous attempts were too timid; the world needed BIGGER QE! The BOJ took this criticism to heart and in 2013 announced a massive QE program that would inject \$1.4 trillion into the Japanese economy. At that time, wise observers said “OK. If QE don’t work THIS time, QE ain’t gonna work.” Guess what? ... It didn’t work. Japan and the rest of the developed world continue plodding along at an anemic pace, while ominous asset bubbles are rising in various world markets. The Fed appears to be especially interested in weaning the US financial system off of monetary heroin, but Dr. Yellen fears that the patient may go into shock. World bond markets were spooked in Q3 when reports surfaced that the ECB was considering “tapering” asset purchases in anticipation of ending QE at some point in the future.

In short, the tea leaves are saying that QE’s days are numbered, and this has played a significant role in the recent rise in interest rates. The 10 year US Treasury yield rose from 1.47% to 1.6% in Q3. But yields have jumped an additional 0.2% in early October. Despite higher Treasury yields, the Barclays Aggregate squeaked out a return of 0.5% in Q3. YTD, the Aggregate is up 5.8%. So far, stocks have brushed off the angst in the bond market. The S&P 500 was up 3.85% in Q3, and 7.8% YTD.

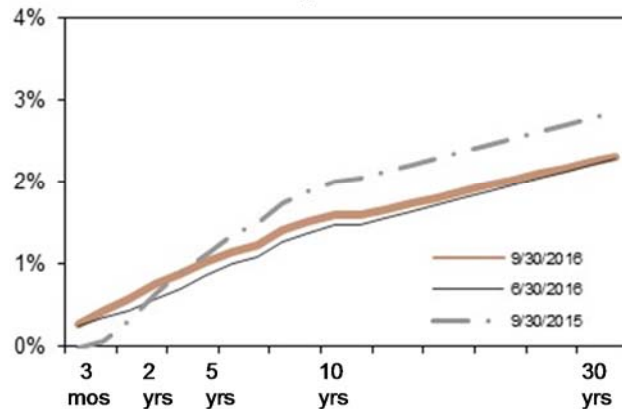
While the US economy continues to languish (the Atlanta Fed’s estimate for Q3 GDP was lowered to 1.9%), it appears that international events (and the Fed) are driving US domestic markets much more than economic data releases. Last June, the UK voted to leave the Eurozone (Brexit). Most were predicting a zombie apocalypse if Brexit passed. Those fears were greatly overdone. However, Brexit is back in the news as it appears that Britain may pursue a path called “Hard Brexit.” “Hard” means that the UK may opt to take a hard line on immigration controls, which could lead to contentious negotiations with the EU regarding the terms of their future relationship. In response, the British Pound was hammered, reaching a 168-year low!



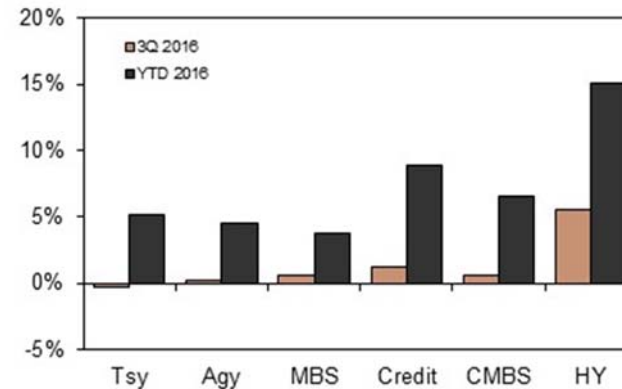
# Fixed Market Commentary

September 30, 2016

### US Treasury Yield Curves



### Sector Index Returns



Speaking of Brexit, apparently the Italians are also having doubts about their future in the EU. On December 4, Italy will hold a referendum on a government reform package. Polls indicate that these reform proposals may be defeated, and could lead to a new anti-EU government. If this happens, a Brexit-type referendum (nicknamed "Italeave") is a strong possibility. If Italeave passed, this would deal a fatal blow to the EU, shaking world markets.

Even if the Fed raises rates in December (as currently anticipated), longer maturity yields could fall if the economy falters. When the Fed last raised rates in December 2015, stocks tanked, long term yields fell and the Fed backtracked. We firmly believe that the S&P 500 is the #1 data point impacting Fed policy. If stocks begin to crack, the Fed will push off tightening into 2017. We will tactically adjust portfolio durations to take advantage of anticipated interest rate moves. Our client portfolios are underweight government securities. US Treasuries currently offer little value, but they do provide liquidity and act as a hedge against "flight to quality" buying. We are overweight credit and slightly underweight mortgage-backed securities.



# Equity Market Commentary

September 30, 2016

The third quarter of 2016 was a positive one for investors as both stocks and bonds moved higher – an uncommon combination. For the quarter, the S&P 500 Index *gained* 3.9% while the Barclay's Aggregate Bond Index *increased* 0.5%. Foreign stocks enjoyed a nice comeback as the Morgan Stanley EAFE Index *jumped* 5.8%. The Balanced Composite Index *appreciated* 2.5%.

While the general direction of the market has been higher, it continues to be plagued by uneven leadership and shorter cycles. Why? Put simply, *uncertainty*. If there is one thing investors hate it's that word. It's important to remember that over the long-term, price action in the market reflects the economic and fundamental reality of the underlying economy and individual companies. Hence, if stock price trends are uneven it's because earnings cycles for companies and industries have contracted into shorter bursts of improvement and deterioration. There are many forces that have converged to create this dynamic. To name a few: massive central bank intervention (a giant experiment with unheard of negative interest rates), volatile election cycle, global economic weakness, global terrorism, a hostile regulatory climate and Fed indecision on the direction of rates. These and other forces have conspired to constrain economic activity. Businesses are weary of investing, hiring and expanding with that backdrop (understandably). If third quarter earnings contract as expected, it will be the sixth consecutive quarter of year-over-year declines.

Though the market has played more offense than defense thus far in 2016, our research has kept us invested more defensively than not. Specifically, we still hold important exposure to consumer staples and utilities, both traditionally defensive in nature. While that exposure has been a drag during the past quarter, the long-term trends are still intact thus far. We will continue to monitor that closely. At the same time, there has been considerable improvement in some formerly depressed economically sensitive areas including industrials, commodities and energy. We have been patient with respect to adding exposure to these early improving areas, adding first to industrials and more recently to energy. We'll see how that continues to develop.

Many market pundits and investors are worried about a bubble in the U.S. stock market. In fact, bullish investors today are an endangered species. As contrarians, this is a good thing. The case for bearishness is well documented but there are important reasons to be bullish. Stock market valuations are not unreasonably high and well within the historical norms. A slow growing economy with contained inflation will limit the Fed's ability to raise rates in any significant way. With medium term nominal bond yields at 1.5%, many investors (starving for returns) will be turning to stocks even if it means taking on additional risk. Are these not buying signals for investors when most turn bearish? We think so. We are confident that the current backdrop of uncertainty will recede as the economic, political, and societal issues are resolved giving way to a normal trending market environment. Until then, investing with a defensive posture is the most prudent approach.

